COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Notice of Inquiry Unbundling of Natural Gas Local Distribution Company Services	)	D.T.E. 98-32

JOINT COMMENTS ON THE UNBUNDLING OF NATURAL GAS LOCAL DISTRIBUTION COMPANY SERVICES OF THE BERKSHIRE GAS COMPANY, BOSTON GAS COMPANY, COLONIAL GAS COMPANY, COMMONWEALTH GAS COMPANY, ESSEX COUNTY GAS COMPANY, FALL RIVER GAS COMPANY, FITCHBURG GAS AND ELECTRIC LIGHT COMPANY AND NORTH ATTLEBORO GAS COMPANY

I. INTRODUCTION

The Berkshire Gas Company, Boston Gas Company, Colonial Gas Company, Commonwealth Gas Company, Essex County Gas Company, Fall River Gas Company, Fitchburg Gas and Electric Light Company and North Attleboro Gas Company (collectively, the "LDCs") submit the following comments in response to the Order Commencing Notice of Inquiry and Seeking Comments, D.T.E. 98-32 ("Order"), issued by the Department of Telecommunications and Energy (the "Department") on April 3, 1998.[1] In its Order, the Department initiated a notice of inquiry ("NOI") proceeding regarding the unbundling of services offered by local gas distribution companies that would encompass all issues relating to the restructuring of the gas industry in Massachusetts, with an initial focus on issues pertaining: (1) to capacity disposition, including both upstream and downstream capacity; and (2) associated cost responsibility. Order at 2-3.

The LDCs agree with the Department that it is appropriate to address these issues in this generic forum as a way to facilitate consideration of important policy issues that underlie the transition to a competitive natural gas market in Massachusetts. By filing joint comments with regard to industry restructuring issues and, in specific, in support of the LDCs' Portfolio Auction,[2] the LDCs believe that the Department's review and determination of key policy

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[1] The Department's Order identified certain issues to be addressed by interested persons in this proceeding. On April 10, 1998, the Department issued a request for additional information on a range of issues that will require the Department's attention in this docket. The LDCs' comments are intended to address the issues set forth in the Department's initial solicitation of comments, as well as the additional issues raised in its subsequent request for information.

[2] The Department's decision to initiate this proceeding stems from a request by the Massachusetts Gas Unbundling Collaborative (the "Collaborative") for guidance on the issue of capacity disposition, which was set forth in the March 18 Status Report (the "Status Report") filed with the Department. Order at 2. A capacity-disposition proposal sponsored by the LDCs that would involve an auction of

issues will be facilitated.[3]

These comments are divided into two sections. The first section sets forth the consensus position of the LDCs regarding: (1) an overview of the fundamental policy determinations necessary to commence the transition to a fully competitive natural gas market in Massachusetts; (2) mandatory capacity assignment; (3) voluntary capacity assignment; and (4) the LDCs' Portfolio Auction approach. The second section responds to the Department's questions set forth in its April 10, 1998 request for additional information.

II. CONSENSUS POSITION OF THE LDCs

A. The Transition to a Competitive Market

1. Overview

The Department has clearly articulated its commitment to move toward a more competitive gas market to further its regulatory goals of providing safe and reliable service at the lowest possible cost (Letter of the Department, July 18, 1997). As a result, Collaborative discussions have been based upon the assumption that the ultimate goal of the Department is to encourage the development of a fully competitive gas market, which would be characterized by a highly liquid market both for gas commodity supplies and for the transportation and storage capacity needed to effectuate the delivery of those supplies into the local distribution system. This goal is premised upon the regulatory principle that, where a workably competitive market exists, market-based prices, rather than rate regulation, will

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the portfolio of gas supply resources held by each company was provided as an attachment to the Status Report. Also included as an attachment to the Status Report was a Competitive Supplier proposal for capacity disposition.

[3] Although the LDCs are filing these comments jointly, each company reserves the right to file separate comments.

more efficiently allocate resources, i.e., market forces will ensure that there is adequate supply at the lowest possible price. This goal is also premised upon the belief that all customers will ultimately benefit from a fully competitive market.

Many Collaborative participants have also operated under the assumption that, where a competitive market can be developed for services previously provided by the local distribution company, the distribution company would cease to provide such services. That is, in a fully competitive market for commodity and capacity, gas companies would no longer serve as gas merchants and would be responsible only for the local distribution function. Ultimately, therefore, their obligation would be limited to the transportation and delivery of supplies brought to the city gate by third-party suppliers who have contracted on a fully competitive basis for both commodity and transportation capacity in order to serve their customers. In such circumstances, the local distribution company's traditional obligation to serve would necessarily be altered since, once removed from the merchant function, local distribution companies would no longer be in a position to ensure reliable and least-cost gas sales service.

There appears to be considerable consensus that the commodity market for gas, which has essentially been fully deregulated at the federal level, is a workably competitive market. Thus, the portion of the merchant function that has been the focus of debate is the capacity component. This includes both upstream pipeline and storage resources (which have historically been procured under long-term contracts) and downstream production and storage assets and entitlements. As described below, it is the local distribution company's role in providing these capacity resources that must be considered by the Department.

If it were clear that a workably competitive market exists or will exist within a definite time frame for these capacity resources, the Department could commence an implementation process that would alter the obligation to serve and permit the local distribution companies to exit the merchant function entirely. In order for the Department to commit to such a course of action, however, there must be certainty that the capacity market will be sufficiently competitive to ensure the availability of an adequate quantity of reasonably priced capacity resources. Such a determination is critical because once this process is undertaken, it cannot be reversed, i.e., once the distribution companies step out of the contracting role, they cannot act as the supplier of last resort or otherwise ensure that adequate supplies will be available. If the market is not sufficiently competitive to ensure reliable capacity resources or if the timing of the transition period does not coincide with the development of the requisite level of competition in the capacity market, then the obligation to serve in the interim period cannot be changed and the local distribution companies must continue to contract for capacity until such a level of competition exists or is certain to exist within a definite time frame.

In evaluating the ability of the market to ensure reliable capacity resources, the Department must take careful note that, although a highly competitive market for gas commodity has been created as a result of unbundling efforts at the federal level, a competitive market structure for interstate pipeline and storage capacity does not yet exist for Massachusetts customers. Although some progress has been made in promoting a competitive market structure for pipeline and storage capacity, there continue to be strong structural and

regulatory impediments to the development of a workably competitive market for these resources. These impediments include the following:

- virtually all of the pipeline and underground storage capacity needed to deliver natural gas into the Commonwealth is under contract to local distribution companies in support of their current sales service obligations;
- Massachusetts is a capacity-constrained area and distribution companies must use interstate pipeline transportation capacity in conjunction with other resources to meet customer requirements in peak periods;[4] and
- the Federal Energy Regulatory Commission ("FERC") continues to impose price constraints on the release of pipeline capacity in the secondary market, which preclude the efficient allocation of capacity.

Given the existence of these impediments, it is generally recognized that the requisite conditions for a fully competitive retail gas market from wellhead to burner-tip in Massachusetts do not yet exist, and may not exist until significant structural and federal regulatory impediments are resolved.[5] It is generally hoped and anticipated that additional

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4 On peak, only about 70 percent of capacity required to meet customer demand is met by pipeline capacity. See New England Gas Association 1994 System Send-Out Survey. In less constrained areas, pipeline capacity may even be discounted on peak. At the same time, the New England region has a relatively low level of market saturation with regard to residential gas service. For instance, only 43 percent of homes in the New England region have gas service and only 31.3 percent of homes in the New England region are gas heat customers (U.S. Energy Information Administration, "Household Energy Consumption and Expenditures 1993," released October 1995). This under-saturation, combined with the rapidly growing demand for natural gas to fuel electric generation facilities, indicates that upstream capacity resources will be increasingly constrained for the next several years, or at least until such time that other resources become available.

5 This situation is distinguishable from circumstances in the electric industry. For instance, the Department's vision of the electric industry is that the distribution company would eventually cease to provide standard offer service and all customers would obtain supplies from a competitive supplier. The distribution company would have the ability to obtain any necessary backstop supplies for those customers at a market-based price on the "spot-market," which would be administered by an independent system operator. Similarly, if a fully competitive and liquid market for capacity existed, the local distribution companies could resort to a spot market to provide backstop supplies without prior planning and procurement efforts. Yet, electric generation is not constrained in the way that gas transportation capacity is constrained. Power plant developers are free to build merchant plants and sell electricity at market-based prices and such facilities are less difficult to site than interstate pipelines. To that end, unlike the interstate pipeline system, FERC has authorized many wholesale suppliers of electric generation to sell electricity at market-based rates.

capacity projects will be developed that will alleviate the current delivery constraints and eliminate the market-power concerns of FERC, although the projects currently under consideration are substantially subscribed to by proposed electric generation facilities. Eventually, however, FERC may decide to remove its current price restrictions which, while designed to preclude the exertion of market power, also restrict the efficient operation of a competitive capacity market. In the meantime, the structural impediments imposed by constrained capacity resources and the regulatory impediments imposed by existing regulatory policies are factors that effectively prohibit unregulated reliance on the competitive market for upstream capacity resources.

Notwithstanding the existing structural and regulatory constraints, there is a strong desire to encourage competition at the local distribution level. To accomplish this, customers and their competitive suppliers must have access to the pipeline and storage capacity resources currently under contract to local distribution companies as they migrate from bundled sales service to transportation service. The manner in which this capacity is made available to customers is key to the equitable allocation of benefits to customers both in the near and long term in the transition to a fully competitive gas market. The Department's decision with regard to the capacity-disposition issue is not susceptible to an abstract resolution, however, because structural and regulatory impediments constrain the transition to a fully competitive capacity market that would reliably serve as a substitute for the planning and procurement functions of the local distribution companies. Thus, the LDCs believe that the manner in which capacity is made available to migrating customers is inextricably linked to the larger policy determinations concerning their traditional obligation

to serve and supply planning and procurement role.

In fact, the development of an implementation plan for the transition period hinges upon the Department's willingness to commit to a course of action that will, within a certain time frame, require complete reliance on the competitive market for capacity management rather than on the planning efforts of the local distribution companies. The LDCs are committed to work with the Department and Collaborative participants to achieve that envisioned end-state, but cannot withdraw from their planning and procurement role until such time as the Department makes the public policy determination, based on its assessment of the competitiveness of the capacity market, that the market can and will provide a substitute for the city-gate services traditionally provided by local distribution companies and reliably deliver adequate gas supplies to Massachusetts consumers.

Therefore, the LDCs propose that the Department establish a five-year time frame beginning November 1, 1998 as the transition period with a interim decision on the local distribution companies' planning and contracting role by November 1, 2001. Prior to November 1, 2001, they would continue to serve in the planning and contracting function and to act as the supplier of last resort consistent with their traditional obligation to serve. If, by November 1, 2001, the Department is convinced that the upstream gas transportation capacity market will be fully competitive by November 1, 2003, the Department could alter the service obligation and allow gas companies to begin the de-contracting process, with the objective of removing them fully from the merchant function by November 1, 2003. If, by November 1, 2001, the Department is unconvinced that a determination can be made with regard to the establishment of a fully competitive upstream capacity market by November

1, 2003, the Department could extend the transition period and the gas companies' contracting role for a certain period to allow the Department additional time to make the necessary assessment and determination. Consistent with this framework, the LDCs propose to auction the right to manage their gas resource portfolios to competitive wholesale marketers for up to a five-year period in order to achieve customer benefits that would not otherwise be available. Until such time that the local distribution companies are relieved of their capacity obligations, the LDCs propose to administer a mandatory-capacity release program in order to maintain system reliability, to avoid the creation of transition costs and to allocate resources to customers on a fair and efficient basis.

2. Industry Restructuring at the Federal Level

The Department's transition from a traditional regulatory framework to a competitive market for natural gas services is made possible by and is a direct reflection of, the efforts undertaken by FERC to restructure the interstate pipeline system. Prior to 1985, the interstate pipelines were, in most markets, the exclusive merchants of "bundled" gas supply, transportation and storage services. Beginning in 1983, FERC issued a series of orders designed to restructure the interstate pipeline system. Order 380 removed the take-or-pay supply obligations of distribution companies contained in their contracts with interstate pipelines and enabled distribution companies to procure commodity resources from a broader segment of the producer market. In 1985, FERC issued Order 436 which provided rules and incentives for interstate pipelines to provide open-access transportation services on a non-discriminatory basis to a wider segment of customers than their traditional local distribution customers.[6] These initiatives were followed by Order 636 which removed the pipelines from their traditional merchant function and imposed a regulatory framework under which interstate pipelines would provide transportation and storage services on an unbundled basis, i.e., as separate services with separate rates.[7] As a result of these initiatives at the federal

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6 *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, F.E.R.C. Stats. & Regs. ¶ 30, 665 (1985) ("Order No. 436"), *modified* Order No. 436-A, F.E.R.C. Stats. & Regs. ¶ 30,675 (1985), *modified further*, Order No. 436-B, III F.E.R.C. Stats. & Regs. ¶ 30,688, *reh'g denied*, Order No. 436-C, 34 F.E.R.C. ¶ 61,404, *reh'g denied*, Order No. 436-D, 34 F.E.R.C. ¶ 61,405, *reconsideration denied*, Order No. 436-E, 34 F.E.R.C. ¶ 61,403 (1986), *vacated and remanded sub. nom.*, *Associated Gas Distrib. v. FERC*, 824 F.2d 981 (D.C. Cir. 1987), *cert. denied sub. nom.* 485 U.S. 1006 (1988).

7 *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol* ("Order No. 636"), FERC Stats & Regs. (CCH) ¶ 30,939, *order on reh'g*, Order No. 636-A, FERC Stats & Regs. (CCH) ¶ 30,950, *order on reh'g*, Order No. 636-B, 61 FERC ¶ 61,272 (1992), *reh'g denied*, 62 FERC ¶ 61,007 (1993), *remanded in part, United Distribution Companies v. FERC*, 88 F.3d 1105 (D.C. Cir. 1996) (referred to as "FERC Order No.

level, the industry has been transformed from the traditional framework, where pipelines purchased gas from producers at regulated prices and transported such gas to consuming markets to be resold to local distribution companies and end users at regulated prices, to a framework in which pipelines transport (at FERC regulated rates) gas supplies to local distribution companies and end users, who have purchased commodity supplies at market prices from a variety of producers and wholesale marketers.

Thus, natural gas has become a commodity, like oil and grain, that is sold at fully decontrolled market prices,[8] which fluctuate in reaction to a wide array of market influences such as, demand, supply, weather, availability of pipeline capacity and other factors. Pipeline transportation charges, however, remain subject to FERC regulation under which maximum rates are established.[9] Underutilized capacity rights can be released and traded in the secondary market, i.e., re-released to other market participants, however, such secondary market releases and subject to the FERC-imposed maximum rate caps and must be made in

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636").

8 The Natural Gas Decontrol Act of 1989 (the "Act") effectively removed all remaining price controls on wellhead or field sales of natural gas and eliminated price ceilings, effective January 1, 1993. 15 U.S.C. § 3301 et seq. (1998). The Act did not deregulate the interstate natural gas pipelines and expressly excluded the sale of any volume of natural gas by any interstate pipeline. 15 U.S.C. § 3301 (21)(B).

9 FERC maintains maximum price caps on interstate gas transportation capacity because it has not yet determined the market for interstate pipeline capacity to be "workably competitive." In a fully competitive market, the market will efficiently allocate and price resources based on supply and demand for a given resource. Thus, excess demand for a scarce resource will increase its price to a point where market participants have the incentive to provide additional quantities of that resource. Because gas transportation capacity is a scarce resource, especially in the Northeast, and because the development of new capacity resources is so costly and complex, it is unclear whether the market for such resources is sufficiently competitive to ensure that additional resources will be developed. If additional resources were not developed, and prices for existing resources were not capped, prices could increase to unacceptable levels.

accordance with certain prescribed rules established by FERC.[10] Thus, while a fully competitive and liquid spot and futures market has developed for natural gas commodity supplies, the market for capacity resources remains in an early stage of development and continues to be significantly influenced by regulatory requirements.

For local distribution companies, the consequences of FERC's efforts to restructure the interstate pipeline system have been two-fold. First, local distribution companies, who as customers of the interstate pipelines had previously purchased all of their firm gas supplies on a bundled basis from the interstate pipelines, were required to take pro-rata portions of pipeline and storage capacity and to make new arrangements for purchasing commodity supplies from producers and marketers that fit with their pipeline capacity and storage portfolios.[11] Through this FERC mandated process, local distribution companies continued to be the holders of primary capacity rights.[12] Moreover, despite the constraints imposed by FERC, local distribution companies were able to take advantage of the newly unbundled market by re-optimizing their commodity portfolios, and make limited adjustments to their transportation and storage resources to enhance their ability to serve their own customers on a more reliable and least-cost basis. At the same time, state public utility commissions began to recognize that significant benefits were being generated as a result of FERC's efforts to

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10 For instance, capacity released on the secondary market cannot be priced at a rate that is higher than FERC's maximum tariffed rate, even where high demand for that capacity may make it more valuable than the maximum tariffed rate.

11 FERC Order No. 636, Docket No. RM 91-11 (1992).

12 FERC established the secondary market for capacity to allow the holder of primary rights to re-market their underutilized capacity, which local distribution companies have during off-peak periods, at prices up to the maximum tariffed rates. Thus, the secondary market is intended to complement the primary market, not to represent a substitute competitive market.

unbundle gas services and to encourage the development of a competitive market for those services that were susceptible to competitive supply. As a result, many state public utility commissions

have taken steps to institute similar unbundling processes with regard to their local distribution systems in order to bring the benefits of additional competition to retail customers.

3. Unbundling at the State Level

Just as the interstate pipelines traditionally served as the exclusive merchants of bundled gas services at the wholesale level, local distribution companies have traditionally served as the sole providers of bundled gas supply in the retail market. As the sole providers of bundled gas services, local distribution companies have had an ongoing obligation to provide safe, reliable, and least-cost service to their customers. Local distribution companies have procured and integrated an array of resources into their portfolios to ensure that bundled gas service can be provided consistent with their obligation to customers.

The Department has witnessed the benefits of unbundling at the federal level and envisions the potential for additional benefits to be gained for customers as a result of unbundling services at the local distribution level. In that regard, the Department has articulated its belief that customers will benefit from the development of a competitive retail gas supply market and its commitment to undertake the process to unbundle local

distribution services to secure such benefits for customers.[13] See Gas Transportation Generic, D.P.U. 85-178, at 10-11 (1987); Mergers and Acquisitions, D.P.U. 93-167-A at 21 (1994); Massachusetts Gas Utilities/FERC Order 636, D.P.U. 94-104-C (1995); Incentive Regulation, D.P.U. 94-158, at 5-7 (1995); Joint Petition of Eastern Energy Marketing, Inc. and Enserch Energy Services, D.P.U. 96-47, at 1-2 (1996); Boston Gas Company, D.P.U. 96-50, at 221 (1996); Department Letters, July 18, 1997 and August 29, 1997. Stated broadly, this unbundling process would require local distribution companies: (1) to price and offer gas supply, transportation and storage services separately to customers to encourage the development of a competitive gas supply market; and (2) to provide competitive suppliers with non-discriminatory access to both customers and the upstream and downstream gas supply resources necessary to serve them.

These unbundling requirements served as the basis for discussions within the Collaborative. In meeting the first requirement, Collaborative participants initiated a rate unbundling process to establish unbundled rates for those LDCs that did not have such rates in place for all customer classes and have also worked diligently to come to agreement on a set of Model Terms and Conditions to govern the offering of services by the LDCs to customers and their suppliers. In meeting the second requirement, it has become apparent that the issue of providing access to upstream and downstream resources, held by local

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13 With regard to the development of a competitive gas market, the Department has stated that such a market would: (1) provide the broadest possible choice; (2) provide all customers with an opportunity to share in the benefits of increased competition; (3) ensure full and fair competition in the gas supply market; (4) functionally separate supply from local distribution services; (5) support and further the goals of environmental regulations; and (6) rely on incentive regulation where a fully competitive market cannot exist, or does not yet exist. Department Letter of July 18, 1997, at 2.

distribution companies to serve customers in a safe, reliable and least-cost manner is inextricably tied to larger policy issues concerning the traditional obligation to serve. The Department's decision with regard to capacity disposition must be consistent with the local distribution companies' obligation to serve and their contracting role during the transition period.

4. Access to Capacity Resources

There are essentially four primary policy objectives in identifying a capacity-release mechanism to make capacity resources available to migrating customers during the transition period: (1) to preserve system reliability; (2) to minimize transition costs; (3) to provide a level of flexibility that promotes effective competition; and (4) to provide an expeditious and orderly transition that minimizes customer confusion.[14]

There are two possible mechanisms for assigning capacity to customers choosing to migrate to transportation service, i.e., mandatory assignment and voluntary assignment, that present differing ramifications when evaluated against these underlying policy

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[14] The Department has previously stated that, in order to assess the reasonableness of an upstream pipeline and storage capacity assignment plan, it will consider whether the plan: (1) facilitates the movement toward a more competitive natural gas supply market; (2) maintains adequate and reliable service; (3) enables local distribution companies to honor existing commitments; and (4) is expeditious, orderly, and minimizes customer confusion. Boston Gas Company, D.P.U. 96-50, at 221-222 (1996) (Phase I).

objectives. The Department's ultimate decision with regard to the structure of the transition-period capacity-disposition program hinges upon a policy determination as to the relative priority of each of those underlying policy objectives, as well as the equitable allocation and timing of customer benefits that are expected to result from increased competition. The LDCs believe that, in making a determination as to the relative desirability of the LDC Portfolio Auction and mandatory assignment of capacity and the competitive supplier's proposal to establish a voluntary assignment system, the Department must make a choice between near-term price reductions for all customers with a progressive transition to a fully competitive market, and the creation of transition costs to be borne by customers in the interest of stimulating marketer participation in the short term. The following sections analyze both mandatory and voluntary assignment with regard to the underlying policy objectives set forth above and the attainment of customer benefits for all customers.

B. Mandatory Capacity Assignment

Historically, local distribution companies have been the sole aggregators and merchants of gas to customers within their respective service territories. In meeting their traditional obligation to provide safe, reliable and least-cost service to customers, local distribution companies have procured and maintained integrated portfolios of supply, transportation and storage contract entitlements. These resources consist primarily of capacity entitlements on multiple upstream pipelines that provide direct access to domestic and Canadian supply resources. Of these upstream pipelines, only two interstate pipeline companies, Algonquin Gas Transmission Company and Tennessee Gas Pipeline Company provide direct service to city gates in Massachusetts.[15] These entitlements can be separated into two categories: (1) long-haul capacity; and (2) short-haul capacity. Long-haul capacity is used to transport gas supply from the producing regions of the lower 48 states and Canada to the city gate and upstream storage fields. Short-haul capacity is used to transport gas supply from upstream underground storage fields located in Pennsylvania, New York, Maryland and West Virginia to the city gate. Local distribution companies have also contracted with pipeline companies for the storage of natural gas in those storage fields. They utilize "downstream" or supplemental facilities within their distribution system, i.e., local production plants, to liquefy, store and vaporize natural gas and liquid propane supplies for peaking purposes.

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15 It should also be noted that Distrigas of Massachusetts Corporation is subject to the regulatory oversight of FERC as an interstate pipeline and provides an alternative for baseload and supplemental supplies to the city gates.

As local distribution companies transition to a new market role, they must equitably allocate capacity assets to migrating customers and their suppliers while maintaining reliable and least-cost service to remaining sales customers. As discussed below, the LDCs believe that mandatory assignment of capacity resources best addresses the underlying policy considerations set forth above. More importantly, mandatory assignment will permit an equitable and seamless transition to a fully competitive

marketplace. See Boston Gas Company, D.P.U. 96-50, at 221-222 (1996) (Phase I).

Under a mandatory capacity-release program, migrating customers are assigned their pro-rata share of the upstream pipeline and storage capacity used to provide bundled sales service to those customers. When such capacity is assigned, it is assigned at maximum tariffed rates, i.e., the local distribution company's cost. Thus, migrating customers retain responsibility for the costs associated with the capacity procured and maintained by the local distribution company to provide traditional firm sales service.

As a result, all marketers assume the same cost structures with regard to the assigned capacity. Arguably, this would reduce barriers to entry and level the playing field for smaller niche marketers. Those marketers would in all likelihood need the capacity to serve customers, and therefore, would not be put at a competitive disadvantage to larger, national marketing companies that already hold capacity resources or have the leverage to obtain such resources at discounted prices.

Once the capacity is assigned to a customer's competitive supplier, the supplier is free to re-market some or all of the capacity allocated to it and to serve its customers with any combination of resources that it may hold. Since all suppliers serving customers with similar load profiles will begin with virtually identical cost structures, suppliers have a strong economic incentive to manage their supply portfolios aggressively and effectively in order to reduce their costs. Thus, the supplier's ability to succeed in the competitive marketplace will be a function of the supplier's own expertise in managing the overall costs of the allocated capacity and in re-optimizing the portfolio. In this way, competitive discipline will work to derive the highest value from the allocated capacity and to generate savings for

customers.

There are two critical features of mandatory assignment: (1) reliability of supply at the city gate is maintained; and (2) no transition costs are created. Because Massachusetts local distribution companies operate within a capacity-constrained region, the preservation of system reliability is a primary concern for the LDCs. For instance, if a supplier obtains pipeline capacity from a source other than a local distribution company to serve customers behind a city gate, that capacity may have a primary delivery point that is different from that of the local distribution company. Since local distribution companies hold the primary firm delivery rights at their city gate stations, the supplier would have to effect delivery to the city gate as a secondary delivery point. During peak periods, or periods of pipeline system constraint, the pipeline will restrict gas flow through secondary delivery points on its system. Thus, the supplier may not be able to use the secondary delivery point to effectuate deliveries to its customer if it is preempted by the local distribution company's use of the delivery point on a primary basis. Since suppliers can lower their costs substantially by using secondary delivery points and interruptible resources to serve their customers, marketers have a strong profit incentive to rely on such resources, which diminishes the reliability of supply where resources are constrained.[16] Under a mandatory-assignment system, suppliers are required to retain firm capacity at primary delivery points, which ensures peak-day deliverability and preserves system integrity.

A second important consideration with regard to mandatory assignment is that the

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[16] Competitive suppliers, unlike regulated local distribution companies, are not required to adhere to design-day planning standards in securing capacity resources.

creation of "transition costs" is avoided. As discussed below with regard to voluntary assignment, transition costs are created where a local distribution company has incurred costs to meet its obligation to serve its customers and those customers are allowed to migrate to transportation service without retaining responsibility for such costs.[17] Since fixed capacity costs do not cease to exist when customers migrate from sales service to transportation service, such costs must be "shifted," or recovered, from remaining customers. Since non-migrating customers are already paying for their share of the fixed costs of capacity, any costs shifted to the non-migrating customer would represent a price increase or "transition cost" to be recovered from that customer. Under mandatory assignment, migrating customers retain responsibility for their pro-rata share of capacity as they migrate, thereby avoiding inequitable cost-shifting and the cross-subsidization of "first-mover" transportation customers by remaining customers.

The principal criticism lodged against the adoption of mandatory assignment is that it would diminish the marketers' flexibility to design a resource portfolio that will produce savings for migrating customers. Because such flexibility has cost-shifting implications, however, a large part of the savings produced would be artificial in that they would result

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17 The marketers contend that voluntary assignment does not create transition costs, but rather "reveals" costs of capacity that are not likely to "be fully marketable . . .[where] customers . . . choose competitive suppliers that best satisfy their individual requirements" (March 18 Status Report, Attachment C at 9). The marketers assert that these costs are not new, since customers are "already paying for those costs in their rates" and that choice "merely makes it easier to see which costs are truly required to meet consumer needs and which are not (id.)." It is important to note, however, that such capacity may not be needed only because the marketer is bringing its own capacity into the equation. Moreover, any costs borne by non-migrating customers as a result of a voluntary-assignment mechanism would represent a new or additional cost for those customers whether or not those costs are "being paid today."

from the avoidance of cost commitments, rather than representing the product of vigorous competition to lower gas costs to customers. Specifically, marketers assert that mandatory assignment would decrease their flexibility in two ways: (1) suppliers may already possess less expensive capacity that could be used to serve migrating customers; and (2) it may be difficult for marketers to manage small pieces of unwanted upstream capacity. The marketers assert that, if they are required to assume the portfolio and costs of the local distribution company rather than using the lowest cost mix of capacity that they can obtain to serve customers, they will not be able to offer savings to a wide range of potential customers.

Yet, it is generally recognized that, once a marketer reaches a "critical mass," i.e., an aggregate load that provides a certain economy of scale, the management of "small pieces" of capacity no longer poses a problem. The LDCs believe that marketers can take advantage of competitive asset-management services to manage their portfolios and that they can also work with individual marketers to help them resolve operational issues. Competition does not require voluntary assignment because marketers have a strong profit incentive to re-optimize their portfolios and to manage the costs of allocated capacity under mandatory assignment, which means that capacity market liquidity will be an inevitable by-product of mandatory assignment. More importantly, the artificial savings produced as a result of the cost-shifting impacts of a voluntary system could hinder the realization of genuine benefits from a competitive market.

C. Voluntary Capacity Assignment

Under voluntary assignment, customers are entitled to their pro-rata share of capacity at maximum rates, but are not obligated to accept assignment of that capacity. Any capacity not elected would be put out to bid and otherwise released by the local distribution company in order to mitigate the unrecovered cost of that capacity. The difference between the local distribution company's contractual obligation for that capacity, i.e., maximum tariffed rates, and the release value for unelected capacity represents a cost to be borne by remaining customers unless some mechanism is established that allows the local distribution company to recover such costs only from migrating customers. In addition to reliability concerns, voluntary capacity assignment raises several important issues that need to be addressed by the Department, including: (1) responsibility for capacity planning and procurement; (2) the implications of FERC's maximum tariffed rates with regard to the local distribution company's ability to mitigate transition costs associated with unelected capacity; and (3) the development of a transition cost-recovery mechanism for non-mitigable costs.

Under voluntary assignment, marketers have the ability to take only those pieces of capacity within the local distribution company's supply portfolio that are competitively priced in comparison to other pieces of capacity at the marketer's disposal.[18] If marketers already hold capacity resources, they will have little economic incentive to select a large portion of the offered capacity. Marketers will leverage their own capacity resources by providing city-gate service through a combination of: (1) their existing resources; (2) local

[18] In addition, because of the existence of FERC-imposed price caps, marketers are protected from paying a higher price for capacity when particular pipeline capacity is in short supply.

distribution company resources that are assignable at maximum rates that have a value greater than or equal to market values; (3) secondary delivery points; and (4) any local distribution company capacity that can be obtained at "bargain-basement" prices through purchases from bulletin boards or other mitigation efforts. This strategy of pursuing the "lowest cost mix of capacity" will seriously endanger the reliability of the system given the lack of excess or "backup" capacity in this region because marketers will have a strong economic incentive to rely on secondary delivery points, interruptible transportation, and less-than-design-year resource-acquisition methodologies to serve customers. Most importantly, marketers will not be subject to the degree of regulatory oversight traditionally exercised by the Department with regard to the operations of the LDCs and the provision of reliable supplies during and after the transition period will be controlled by the competitive market and the service contracts executed between suppliers and customers.

Not only can such a framework cause reliability concerns particularly in a market characterized by capacity constraints, but it also establishes a mechanism for marketers to

convert their unused or excess capacity into underutilized local distribution company capacity. That is, a marketer may have excess capacity in its own portfolio that is unusable until such time that the marketer picks up particular customers from the local distribution company's system. At that point, the marketer has the opportunity to take assignment of portions of the local distribution company's capacity resource offerings that would complement its own excess capacity. Thus, the marketer's excess capacity becomes useful to the marketer and unelected capacity is left behind for the distribution company to manage. As a result, cost responsibility for the underutilized capacity is shifted to the local distribution company's customers in the form of a transition charge. Because the marketer's capacity was not procured as part of a regulatory obligation to serve, the collection of the marketer's stranded costs from local distribution company customers would be particularly inappropriate.

Under a voluntary program, the local distribution company does not have the ability to foresee how marketers will value its capacity in comparison to resources within the marketer's portfolio, and therefore, the local distribution company would be unable to determine how much capacity would be needed by customers on a going-forward basis. In such circumstances, the local distribution companies would no longer be in a position to contract for and manage capacity and would not seek to renew capacity contracts as they expire. Such a transition can occur only if it is clear that the market for upstream capacity is sufficiently competitive to allocate such resources efficiently. However, the market for upstream capacity is not yet workably competitive. Prices are still regulated by FERC, FERC continues to articulate concerns regarding the market power of the pipelines, and the timing

and availability of new capacity resources is uncertain. Therefore, there is concern among the LDCs and others that the forces of supply and demand cannot be relied upon to ensure adequate supply and reasonable prices and, in fact, cannot be relied upon until certain regulatory impediments are removed and a determination is made that the market is sufficiently competitive. Although it may be argued that this presents a "chicken and egg" dilemma, the LDCs believe that the planning and procurement functions must be maintained until such a determination is made. Requiring the LDCs to retain this function is inconsistent with the requirement to release such capacity to migrating customers on a voluntary basis, which presupposes a determination that local distribution companies will no longer be responsible for planning, procuring and contracting for capacity as contracts expire.[19]

An additional issue relating to a voluntary-assignment mechanism is the local distribution companies' obligation to manage and mitigate the costs associated with unelected capacity. An important consideration regarding the local distribution companies' mitigation efforts relates to the FERC-imposed rate caps on releases of transportation capacity on the secondary market. Although the local distribution companies would bear the responsibility for mitigating any costs associated with unelected capacity, the price paid for released capacity cannot be in excess of the maximum tariffed rates, even if such capacity would have a higher value in the competitive marketplace. Thus, to the extent that capacity is offered for release, it can only be discounted. Benefits arising from capacity with a market

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19 If the Department were to determine that the competitive market could safely provide for capacity resources, the local distribution companies could begin the de-contracting process and complete their exit from the merchant function. The LDCs believe that, during this process, a mandatory-release system is a far more appropriate approach to maintain system reliability and avoid the first-mover advantage created as a result of the cost-shifting implications of a voluntary program.

value in excess of the maximum rate would accrue to marketers who are able to elect premium capacity at maximum tariffed rates, while leaving other capacity resources behind or purchasing them at deeply discounted prices.

Conversely, because voluntary capacity assignment allows marketers to refuse assignment of capacity resources associated with a migrating customer, marketers have a strong incentive to wait for such capacity to be released on the secondary market at discounted prices. Marketers would be unwilling to take capacity at maximum rates when there is the possibility that they would be put at a competitive disadvantage to those marketers that elect to wait for the local distribution companies' capacity to become available on the secondary market at a less expensive basis. Moreover, marketers have the ability to re-market such capacity at prices exceeding maximum rates by combining it with supply and offering it to the market on a bundled basis. By assigning capacity on a mandatory basis at rates that FERC has determined to be just and reasonable, marketers will have the incentive to manage costs associated with the capacity that they do not need, but also will have the ability to bundle valuable capacity with supply to achieve a return in excess of maximum rates.

An additional concern with regard to the local distribution company's mitigation efforts is that the marketing of existing capacity would result in the migration of capacity to other regions since local distribution companies would be under an obligation to obtain the maximum value for unsubscribed capacity. Moreover, under a voluntary program, local distribution companies would immediately begin to de-contract existing obligations and refrain from taking on new capacity obligations in order to avoid transition costs. Absent a workably competitive market, these actions could aggravate reliability concerns by creating

additional capacity constraints and further jeopardizing deliverability during peak seasons as capacity migrates to other regions.

A voluntary-assignment approach, also requires the Department to make a determination as to the responsibility for the resulting non-mitigable transition costs and to establish a recovery mechanism for such costs. Several mechanisms have been discussed within the Collaborative, and because the Competitive Supplier Proposal uses a voluntary-assignment mechanism, a cost-recovery mechanism has been proposed to the Department.

One cost recovery approach is to assign all transition costs to migrating (transportation) customers who are responsible for creating such costs.[20] Retail marketers object to this approach since, economically, it has the same effect as being assigned capacity on a mandatory basis, i.e., marketers are unable to shed costs associated with unwanted capacity in order to provide migrating customers with cost savings. Since this mechanism would not allow costs to be shifted to non-migrating customers, marketers would have little incentive to leave allocated capacity behind.

Another alternative is to collect such costs from all customers on the system, both those who have migrated to transportation service and remaining sales customers. This approach requires non-migrating customers to subsidize the savings attained by migrating customers and inevitably results in cost increases for non-migrating customers. Some have proposed to cap such increases and to collect any excess amounts from transportation

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[20] Additionally, it is unclear precisely how such an approach would address cost-shifting between migrating customers. If a uniform charge were applied to all migrating customers, marketers would be faced with a strong incentive to minimize the election of offered capacity. This incentive would be reduced if the transition charge were based on the amount of released capacity that each customer selected, but such an approach would be extremely difficult to administer.

customers. The LDCs believe that any costs shifted to non-migrating customers would effectively require those customers to shoulder the burden of costs that bear no relation to their cost of service. Such a result would be inconsistent with the Department's well-established cost incurrence principles. See, e.g., Bay State Gas Company, D.P.U. 92-111, at 54, 283-284, 311-312 (1992). Moreover, the LDCs believe that such action would be inconsistent with the Department's stated objective to ensure that all customers have the opportunity to enjoy the benefits of a competitive market. The LDCs believe that the Legislature, in considering and authorizing electric industry restructuring, was careful to develop a framework that would not advantage early movers to the detriment of customers electing not to participate in the competitive market.

The Competitive Supplier Proposal suggests a third approach that would create a transition cost pool and defer some or all of those costs for later recovery. This proposal has several elements that are objectionable and inconsistent with Department ratemaking principles. As described by its proponents, the Department would establish a transition cost recovery pool that would constitute a repository for transition costs associated with unelected capacity, and for revenues associated with mitigation activities undertaken by the local distribution company. The transition cost pool would also accumulate carrying charges on any over- or underrecoveries.

The LDCs believe that this approach essentially constitutes the imposition of a transition charge to all customers, migrating and non-migrating, but adds an even more undesirable twist by deferring recovery of some or all costs to future customers who, as a result, would be forced to subsidize current customers. For all its complicated aspects, this

approach essentially represents the netting of unelected capacity costs against revenues resulting from mitigation efforts. This approach has no impact on the level of transition costs created as a result of voluntary capacity assignment. In fact, the plan could actually increase such costs for customers since carrying charges would accrue. The LDCs believe that the proposal creates unnecessary and complicated regulatory burdens for the Department, the LDCs and other market participants, since it would require the development of an intricate cost-recovery scheme incorporating a range of variables and creating unnecessary cost implications for customers.

In general, the LDCs believe that utilization of a deferral mechanism is unworkable for several reasons. First and foremost, savings attained by current customers as a result of migration would be borne by customers remaining on the system and future customers. Such a construct would allow marketers to participate in the developing market at a time when costs can be shed, with no guarantee that they would continue to serve their customers at the time that the costs start being collected. At the very least, should the Department adopt a voluntary release mechanism, such costs should be recovered on a current basis from migrating customers in a way that will provide marketers with an incentive to take the local distribution company's capacity. Deferral of expenses creates unnecessary accounting complications as well as shifting the recovery of expenses to future generations of customers.

D. LDC Portfolio Auction

The LDCs propose to auction the management of their upstream gas transportation capacity, storage rights and gas supply commodity resources to a portfolio manager for up to a five-year term, consistent with the time frame proposed by the LDCs for the transition

period. By outsourcing the gas supply function to an experienced and resourceful portfolio manager that is able to re-optimize, aggregate or leverage the value of the LDC's portfolio resources, the LDCs can realize cost savings that are not otherwise attainable and can pass those savings through to customers in the form of immediate price reductions. In order to provide the portfolio manager with the necessary flexibility to achieve this objective, the portfolio manager would take assignment of, or act as an

agent[21] on, the LDC's upstream transport, supply and storage contracts and would assume responsibility for all associated contract costs. The portfolio manager would provide the LDC with a city-gate gas supply to meet the LDC's total gas requirements at either a market-based price or a fixed price depending on the final terms of the outsourcing contract.

The portfolio manager would work closely with the local distribution company to coordinate gas requirements and deliveries with the local distribution company's gas supply planning personnel. As a result of this arrangement, the Portfolio Auction would meet several important objectives, such as: (1) transferring the management and utilization of capacity resources currently under contract to the LDCs to the competitive marketplace; (2) functionally separating local distribution company supply operations from the local distribution function; (3) providing migrating customers and their competitive suppliers with access to the capacity resources held by the LDCs during the transition period; and (4) providing all customers with lower prices as a result of efficiency gains achieved through competitive market capacity transactions without shifting of current cost commitments.

The outsourcing of a local distribution company's portfolio is a relatively new concept that has developed in response to the current industry trend toward deregulation

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21 Most of the contracts held by the local distribution companies are assignable, however, some supply contracts may not be assignable. Thus, any unassignable contracts could either be managed by the local distribution companies at the direction of the portfolio manager or managed by the portfolio manager under an agency arrangement.

and the emergence of a competitive gas market. This development has occurred because local distribution companies continue to have an obligation to hold sufficient resources for peak day conditions and also face increasing pressure to procure and manage such resources consistent with the development of a competitive gas market. As regional participants subject to various regulatory restrictions, local distribution companies are constrained in their ability to engage in the national capacity trading market for the purpose of deriving greater efficiencies and cost savings from their portfolios. The Portfolio Auction offers a market-based solution to capture such efficiencies for the sole benefit of customers. Moreover, because this process is somewhat unique, the LDCs anticipate a high level of interest by wholesale marketers in bidding on these portfolios, which has the potential to result in very attractive and innovative bid proposals.

1. The Portfolio Manager

Of the utmost importance to the LDCs is the ability of the portfolio manager to provide a reliable gas supply to the city gate to meet system requirements. Thus, potential candidates for portfolio manager would be competitive wholesale gas marketers with experience in transporting gas from the producing regions of the country to city gates. Market participants competing on this level would have access to many supply and pipeline interconnect alternatives that enhance their ability to manage the LDCs' portfolio resources efficiently and to provide a reliable city-gate supply. To that end, the LDCs would seek portfolio managers that have, at a minimum, the following qualifications: (1) a proven ability to deliver reliable gas supplies; (2) financial strength and stability; (3) an ample pool of supply and capacity resources to generate synergies and optimization opportunities coupled with the local distribution company's portfolio resources; and (4) an established market presence and experience in portfolio management.

The portfolio manager has an enhanced opportunity to derive heretofore unrealized efficiencies and additional cost savings from the resource portfolio for several reasons. First, the portfolio manager, as a competitive wholesale marketer, has the ability to manage the resources from a national perspective and to realize higher capacity and gas resale values than may be available in regional markets. Because the local distribution company has a limited number of resources and must be prepared to provide service under a range of supply exigencies, its ability to engage in release and resale opportunities is constrained. The portfolio manager, however, operates on a national scale with substantially more flexibility

and expertise to utilize a broad range of resource alternatives to ensure a reliable city-gate supply.

Financial instruments are another important tool commonly used by experienced portfolio managers for risk management. For instance, the portfolio manager could agree to provide a city-gate supply to the local distribution company at a certain price per unit, which would be below the unit price offered by the local distribution company, and use

financial risk management instruments, such as a "call option," to reduce the cost of gas.[22] The portfolio manager may also use financial instruments to mitigate any capacity-related risk.

2. The Portfolio Auction Process

A key element of the Portfolio Auction would be the Request for Proposals process ("RFP"). The LDCs would structure and implement this process with two overriding objectives in mind: (1) to maximize the value of the bids for the portfolios; and (2) to secure the services of a portfolio manager that has the expertise and financial resources necessary to provide a highly reliable gas supply to the LDC's city gate. These objectives are incorporated into each step of the RFP process. The LDCs also believe that it will be important to establish a uniform RFP process, to the maximum extent possible, because any variation has the potential to introduce a distortion into the process that could affect the interest level of bidders or the bid values achieved on a particular portfolio.

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22 A call option would be created where the portfolio manager purchased the right to buy gas at a certain price per unit. The purchase of a call option establishes a cap or maximum price that would be paid by the portfolio manager for a given gas commodity resource. If gas commodity prices were to increase to the price established by the call option, the portfolio manager would exercise its option to purchase gas supply at the established level. In this way, the portfolio manager can offer a certain city gate price to the LDC and set a cap on its liability for the cost of that supply.

a. Maximizing the Bid Value

The LDCs propose to initiate an RFP process designed to maximize the bid value attained for the portfolio, while allowing bidders the flexibility to propose alternatives or innovations that would enhance the value of the portfolio for the benefit of customers. The structure of each individual portfolio would reflect the particular characteristics of the local distribution company's service territory and resource contracts.[23] In preparing for and issuing the RFP,[24] each local distribution company would compile a detailed overview of its resource contracts and system requirements, including: load profile information; historical and projected sales and transportation service data; forecast peak-day requirements analyses; summaries of supplemental resources used in providing balancing or swing services; and any other detailed information necessary for the bidding process.

After discussions with wholesale marketers regarding the portfolio auction, the LDCs have determined that there are several factors, which should be incorporated into the RFP, that would affect the bid value, including: (1) the establishment of annual customer migration levels; (2) the type of capacity assignment employed to transfer pro-rata capacity rights to migrating customers; and (3) the structure of the pricing element.[25] In general,

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23 For instance, a portfolio may include the right to manage an LDC's downstream assets or, where an LDC's service territory includes non-contiguous geographical divisions that are served by mutually exclusive upstream asset portfolios, the LDC may elect to auction separately the rights to manage the portfolio associated with a particular geographical division.

24 The LDCs provided a draft model RFP as an appendix to the LDC Portfolio Auction Proposal submitted in the March 18 Status Report.

25 Consistent with the transition framework set forth above, the LDCs propose to set a contract term of up to five years. Generally, the natural gas commodity market is highly sensitive to weather fluctuations and to price movements in other energy commodity markets. Thus, a relatively longer contract term would provide the portfolio manager with reduced risk of short-term weather fluctuations and short-term commodity price movements. More importantly, the LDCs believe that the contract

establishing RFP parameters that reduce risk for the portfolio manager will contribute to an increased bid value.

With regard to limitations on customer-migration levels, wholesale marketers have indicated that, to the extent that the migration rate is predictable or controlled, the ability of the portfolio manager to extract value from the portfolio resources should increase. Some options for stabilizing migration include the establishment of maximum annual levels of customer migration and/or "open-season" enrollment periods, rather than continual enrollment. Since such restrictions lend an element of predictability and control to the portfolio manager's administration of the portfolio, the restrictions have the potential to increase the value of the bid.

At the same time, it is important to note that such restrictions have the potential to inhibit the rate of customer migration because customers may lose interest if they are unable to participate when desired. The LDCs believe that such a mechanism may be unnecessary where capacity is released on a mandatory basis, since a mandatory release mechanism would provide a large measure of predictability to the portfolio manager. This issue can be explored and resolved within the context of the RFP process, by providing bidders with the opportunity to propose such a mechanism and to link that proposal to the bid value. As a result, it would be possible to balance the level of incremental value attainable and the effect on the development of a competitive gas market.

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term should correspond to the length of the transition period since it would be difficult to change outsourcing providers during the transition phase given the complexities involved in engaging a portfolio manager and transferring management rights and obligations to that provider.

With regard to capacity disposition, several wholesale marketers have indicated that a mandatory release mechanism would generate the most value to customers because it provides the greatest level of system reliability through the transition period, eliminates cost-shifting and cost-responsibility issues, and creates a level playing field for all retail competitors.[26] It is important to note that transition costs created as a result of customer migration under a voluntary-assignment plan would not be absorbed by the portfolio manager. Bidders would incorporate a mechanism, either explicitly or implicitly, to eliminate any financial exposure associated with the costs of unelected capacity. That is, the bidders will either offer a bid value that is dependent upon the establishment of a cost-recovery mechanism or a bid value that incorporates the cost exposure.[27] The LDCs believe that a voluntary-assignment program would inevitably diminish or eliminate the benefits to all customers. Thus, the LDCs propose to incorporate a mandatory-assignment mechanism as an element of the RFP.

With regard to the pricing mechanism, the LDCs propose to solicit bids for the right to manage the portfolio and to request that the bid price constitute the default service per unit price, i.e., the bid price would be in the form of a per unit price for gas delivered to the city

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26 In response to the retail marketers concerns regarding the management of small "pieces" of capacity as a result of mandatory assignment, some wholesale marketers have indicated that such costs can be mitigated by allowing the wholesale marketer to manage the retail marketer's capacity until the retail marketer reaches "critical mass" with regard to their transportation alternatives. Other wholesale marketers have suggested that a minimum assignment size could be established.

27 The LDCs plan to structure the auction such that the bid price would be in the form of a per-unit price for city-gate supply. To the extent that the bidder believes it will be at risk for capacity costs associated with unelected capacity, it will seek a higher price for the city gate supply. Thus, while not explicit, default sales service customers would be paying transition costs created by the voluntary assignment mechanism.

gate as the LDC's default service gas supply.[28] The LDCs propose to establish a bid price floor to ensure a default sales service price that is less than the current price paid by local distribution company customers. For instance, where the local distribution company may currently supply bundled sales service at the rate of $4.10/Mcf, the bidder may be willing to provide gas supply delivered to the city gate at a price of $3.90/Mcf. This would result in direct savings to all sales customers of $0.20/Mcf.

The LDCs propose to structure the RFP to provide the bidder with the flexibility to offer either a fixed per-unit price for the period of the contract or an indexed pricing mechanism to allow the commodity price to float, based on market-based indicators. Each alternative has advantages and disadvantages. Floating price, or indexed prices, are based on market indicators. Thus, this pricing structure would allow the price for default service to track market conditions, which reduces risk for the portfolio manager, but at the same time, would expose customers to market price fluctuations.[29] Pricing gas at a fixed price would eliminate commodity fluctuations and insulate the customer from price increases, but would also deny the customer the benefit of price decreases. Moreover, a fixed price may not provide accurate price signals to customers and may include an unacceptable risk premium, i.e., reduce the bid value to protect the portfolio manager from price fluctuations. The LDCs believe that, similar to the provisions for limitations on customer migration, this issue is best resolved within the context of the RFP process where it will be possible to

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[28] This assumes that the LDC has elected to include its downstream or supplemental supplies as part of the portfolio auction. If the LDC has not included such resources as part of the portfolio, the cost of such resources must be added to the per unit city gate supply price to derive the default service price.

[29] A portfolio manager could purchase floor and ceiling-type pricing options that would protect customers from radical price swings.

balance the level of incremental value attainable and the ramifications for customers and the emerging competitive market.

b. Ensuring a Reliable City-Gate Supply

The second overriding objective of the Portfolio Auction proposal is to secure the services of a portfolio manager that has the expertise and financial resources necessary to provide a reliable gas supply to the city gate. Once the RFP is issued and bids are received, the LDC will engage in a selection process to evaluate potential portfolio managers. The LDCs will make judgments as to the suitability and capabilities of particular candidates based upon several factors, including: (1) the proposed pricing structure; (2) the level of experience and proven expertise with regard to supply reliability and portfolio management; (3) financial stability and capabilities; (4) availability and

quality of supply and capacity resources to ensure optimization opportunities with regard to the LDC's portfolio resources; (5) quality and workability of portfolio management plan; and (6) knowledge of regulatory policies and procedures at the state and federal level.

Each LDC would engage in negotiations to create a portfolio-management contract that will protect the LDC and its customers, subject to the approval of the Department, and which would include, at a minimum, performance standards and contract default provisions. The LDCs would retain full recall rights on the capacity and commodity resources assigned to the portfolio manager to ensure the integrity of the city-gate supply and to allow for recall in the event of non-performance. The LDCs would not provide the portfolio manager with any contractual rights to alter permanently the LDC's capacity and commodity arrangements.

In general, as a result of the contractual arrangement, the LDCs anticipate that they would retain responsibility for determining the pro-rata shares of capacity to be released to migrating customers and for administering the mandatory capacity-assignment program. In addition, the LDCs would provide default service to any customers who have not yet chosen a competitive supplier. Lastly, the LDCs propose to retain their planning and procurement role until November 1, 2001, or until such time that the Department determines that a workably competitive market for upstream capacity exists or will exist, and allows the LDCs to exit the merchant function completely by removing their traditional obligation to serve. The LDCs also propose to work with the portfolio manager, as well as retail marketers, regulators and interstate pipelines during the transition period to review contract renewal decisions. The portfolio manager would assume responsibility for nominations of supply and for the day-to-day management of the gas-transportation, storage and commodity resources.

Because the LDCs would retain full control over the portfolio resources in the case of non-performance by the portfolio manager and because the LDCs would remain subject to the regulatory authority of the Department, this arrangement would in no way alter the Department's ability to ensure that customers have a reliable and least-cost gas supply.

3. Conclusion

In meeting their traditional obligation to serve a wide range of customer requirements, the LDCs have assembled integrated portfolios for both the transportation and storage of natural gas. These portfolios were designed to balance cost with reliability and efficiency and reflect the individual characteristics of each LDC's system, including access to supplemental facilities, geographic location, customer mix, and weather considerations. The LDCs expect that, over the course of the transition period, they will be required to provide a level of standby service, i.e., to serve as the suppliers of last resort in the event of supply exigencies. In meeting this obligation, the LDCs must necessarily rely on their portfolios to ensure that sufficient resources are available to maintain continued operation of the system under all circumstances.

At the same time, the LDCs recognize that their in-house ability to leverage these assets to derive incremental efficiencies and cost savings for customers on the open market is limited. Because wholesale marketers have larger portfolios, they have more flexibility to use and manage capacity resources on a national basis and, as a result, have a broader vision and greater depth of expertise. The LDCs recognize that there is the potential to achieve savings for all customers during the transition period while maintaining the necessary level of resources to ensure system reliability. The LDCs believe that the Portfolio

Auction meets the Department's policy objectives and can provide immediate benefits to all customers as a result of placing the LDCs' resources in the hands of the competitive market.

III. RESPONSES TO DEPARTMENT QUESTIONS

A. Potential for Stranded Costs at Each LDC

Each LDC should provide a full description of the upstream and downstream assets and gas supply resources that theoretically could be "stranded" costs due to the unbundling process. The description should include, but not be limited to, the annual demand (fixed) charges associated with each resource, the routes and characteristics of service associated with each resource, the expiration date of the contract under which the obligation exists, and the terms and conditions (such as evergreen clauses) that affect extension of each contract.

To the extent possible, the response should include both matrix tables and text discussion of the extent to which these potential stranded costs are affected by migration of customers to transportation service, voluntary assumption of capacity, and mitigation of stranded costs. Please indicate the potential impact on the average annual residential bill for service.

Indicate the capacity contracts and volumes subject to expiration during the years 1998-2003 and indicate the percentage of the LDC's total capacity represented by each contract. Please indicate the notice period required to terminate or renew those contracts.

Attached as Exhibit 1 is a summary of the upstream gas transportation capacity, underground storage and gas commodity contracts held by each of the eight LDCs sponsoring these comments. For each contract, the LDCs have provided information regarding: (1) maximum daily quantities ("MDQ") and the annual contract quantities ("ACQ"); (2) total demand costs; (3) contract expiration date; and (4) contract renewal terms. Each LDC has provided a schematic to illustrate the transportation routes associated with these contracts.

Each company has also completed a matrix of costs relating to unavoidable upstream gas transportation capacity. All of these costs were incurred by the LDCs in accordance with

their obligation to serve and in order to meet the standards for reliability approved by the Energy Facilities Siting Council and the Department in cases reviewing the LDCs' supply plans and demand forecasts. The costs relating to upstream and downstream assets and contracts are presently included in base rates or the CGAC.

The LDCs do not believe that the unbundling process will identify "stranded" costs, as that term has been used in the electric industry. Stranded costs are embedded costs that are not recoverable in a deregulated, competitive market, i.e., stranded costs are viewed as the difference between the embedded cost relating to an asset or contract and the market price for the same resource. The LDCs believe that the true market value of their upstream and downstream resources is not below the unregulated, competitive market price for those resources. However, as described in Section II.A above, because of existing price regulation at the federal level, the release of upstream assets to the existing "market" would not identify an unregulated market price for the assets. Nonetheless, a voluntary capacity-release mechanism would create artificial "stranded" costs resulting from the under-subscription of capacity that is offered to customers and their marketers.[30]

The matrices set forth in Exhibit 1 show the level of transition costs that could result from a voluntary capacity-release system based on varying assumptions concerning: (1) the number of customers who will migrate to transportation service; (2) the amount of capacity that migrating customers will assume; and (3) the amount of revenues that would be received

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[30] The LDCs' recommended mandatory approach does not artificially create these "stranded" costs since customers continue to be responsible for the same level of costs as exists today. The unbundling process would thus release the capacity to customers so they can gain access to the competitive gas commodity market without any potential cost shifting that would result from the creation of "stranded" costs.

through mitigation efforts to market the unelected capacity. The Y-axis of the matrices is the percentage of load that migrates to transportation service and the X-axis is the percentage of costs that are recovered through subscription to the released capacity by the customer and through LDC mitigation efforts. Exhibit 1 also includes a textual discussion regarding: (1) the extent to which transition costs may be created as a result of migration of customers to transportation of service under a voluntary capacity assignment program; and (2) relevant contract termination and renewal terms and conditions.

B. Capacity Assignment Principles

Discuss the merits and limitations of the voluntary assumption and mandatory capacity assignment processes that have been suggested as the way by which current LDC capacity should be made available to end-users or marketers or, alternatively, remain with the LDC even if the LDC no longer requires that capacity in the transition to an unbundled market. Describe how each alternative has been used to implement unbundling in other jurisdictions.

Discuss the merits and limitations of the portfolio auction process. The discussion should consider the use of the portfolio auction with the separate alternatives of mandatory assignment and voluntary assumption of capacity to end-users that choose another source for their gas supply. Describe how these alternatives have been used to implement unbundling in other jurisdictions. Indicate the criteria, other than price, that should be considered in determining which bidder should be selected. Discuss the issue of market power and indicate what types of restrictions, if any, should be placed on the winning bidder to address potential affiliate abuses.

Please include in this discussion an explanation as to how the "slice" and "path" assignments might be implemented. An example, using a hypothetical service territory and the range of capacity resources, would be useful.

Address how each proposal will affect the entry and number of competitors in the Massachusetts market for the short and long term.

1. Mandatory and Voluntary Capacity Assignment

The merits and limitations of voluntary and mandatory capacity assignment are

discussed above in Sections II.B and II.C. The LDCs believe that these two alternatives present the Department with a clear, but critical policy question for consideration and determination. That policy determination can be described as follows: A voluntary capacity-assignment program is more attractive to competitive suppliers because they would be permitted to avoid cost commitments associated with the integrated resource portfolios of the LDCs, and therefore, are afforded a high level of flexibility with regard to the reoptimization of their own capacity and supply portfolios. This flexibility, however, will create transition costs that must be recovered.

Unless all net non-mitigable costs associated with the unelected capacity are recovered solely from those customers migrating to transportation service, non-migrating customers will incur cost increases as they assume responsibility for the costs avoided by migrating customers and their competitive suppliers. Thus, voluntary capacity assignment would provide the greatest opportunity with regard to participation by competitive suppliers, but that opportunity would be underwritten by cost increases to non-migrating customers, who effectively would be required to subsidize savings offered by suppliers to migrating customers. The LDCs also believe that voluntary capacity assignment could create serious reliability problems since competitive suppliers would have the flexibility and incentive to use secondary delivery points and interruptible resources to serve firm customers. Under a voluntary system, customers would be required to rely upon competitive forces to ensure deliverability to the city gate rather than relying on the efforts of the LDC to plan for and procure capacity resources in accordance with their traditional service obligation.

Mandatory assignment would provide the greatest level of system reliability,

eliminate cost-shifting and cost-responsibility issues, and create a level playing field for all competitors. Mandatory assignment, however, is less attractive to competitive suppliers because it requires them to manage capacity that they may not need because it is more expensive or is otherwise undesirable when taken in combination with other resources held in their portfolios. Thus, retail marketers claim that competition will be slower to develop should a mandatory-assignment program be instituted because fewer marketers would be willing to participate up front. Fundamentally, the Department must balance the desire to spur a relatively higher level of participation by competitive suppliers in the short term with the desire to avoid negative impacts on non-migrating customers and system reliability as a result of the transition to a fully competitive market.

2. LDC Portfolio Auction

The merits of the LDC Portfolio Auction proposal are discussed above in Section II.D. As stated above, the LDCs believe that this proposal would meet several important objectives of the Department, such as: (1) transferring the management and utilization of capacity resources currently under contract to the LDCs to the competitive marketplace; (2) functionally separating supply operations from the local distribution function; (3) providing migrating customers and their competitive suppliers with access to the capacity resources held by the LDCs during the transition period; and (4) providing all customers with lower prices as a result of efficiency gains achieved through competitive market capacity transactions without the avoidance of current cost commitments.

Although it is theoretically possible to incorporate either a voluntary or mandatory-assignment mechanism into the Portfolio Auction process, the relative advantages

and disadvantages of those mechanisms as set forth above are no different when utilized within the Portfolio Auction process. It is important to note that the portfolio manager is unlikely to be willing to accept the risk of cost recovery with regard to the costs associated with unelected capacity and, as a result, will seek either to establish an explicit mechanism to ensure cost recovery or will offer a bid price that would effectively indemnify the portfolio manager against such risk. Thus, just as a voluntary-assignment mechanism will create transition costs and cost responsibility issues without a portfolio auction, voluntary assignment will diminish the LDCs' ability to maximize bid values for the benefit of all customers within the context of a portfolio auction.

Two examples of the portfolio auction approach in the Northeast are the Providence Gas Company ("Providence")/Duke Energy arrangement and the Brooklyn Union Gas Company ("Brooklyn Union")/Enron Capital and Trade Resources Corp. ("Enron") arrangement. The Rhode Island Public Utilities Commission formally approved Providence/Duke Energy arrangement on October 1, 1997. The Providence arrangement employs a mandatory-release mechanism and caps migration at 10 percent of total throughput for each year of the three-year contract term. As of August 1, 1997, customers were allowed to switch to competitive suppliers and by November 1, 1997, migration had reached the capped level for the year. As a result of the portfolio management arrangement with Duke Energy, Providence was able to provide its default service customers with a 4 percent reduction to their sales service prices for the three-year period.[31]

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[31] In approving the price stabilization plan based on the Providence/Duke Energy arrangement, the Rhode Island Public Utilities Commission stated:

Brooklyn Union recently entered into a portfolio management contract with Enron Capital and Trade Resources Corp. Brooklyn Union has implemented a voluntary assignment program. Representatives of Brooklyn Union have indicated that unelected capacity may be used to meet system growth needs, but that to date, few suppliers have elected to take such capacity, and therefore, the amount of unelected capacity has outstripped system growth. Thus, a charge has been imposed upon the LDC's core merchant service customers to effect recovery of such costs.

The LDCs do not believe that market-power problems will arise as a result of the portfolio auction approach. Market power, or the ability to control supply and price, inhibits the attainment of economic efficiency, and therefore, impedes the development of a competitive gas market. Market power is not a problem where, as is the case now, there are many suppliers participating in the market and no individual supplier has the ability to control supply and price. The LDCs are aware that a variety of wholesale marketing entities are currently interested in participating in the portfolio auction process and are confident that a sufficiently large number of marketers would be involved in the bidding process to ensure that the price established for default service would be the product of vigorous and even-handed competition. Although retail marketers may complain that the resulting default price would be too low to compete against, that price would constitute a market price since it

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> Clearly the [plan] represents an integrated, comprehensive, future-looking strategy to meet the needs of the Company, the ratepayers and the State. At the heart of this plan is the three-year gas supply contract which brings an immediate price reduction and locks in the lower price for three years.

Docket No. 2581, at 21 (1997).

would have been derived as a result of a competitive bidding process. Moreover, the LDCs anticipate that several different marketers would win portfolio management rights and that the Department would be unlikely to approve portfolio management contracts that allowed a single entity to control multiple portfolios.

3. Slice of the System versus Path

Exhibit 2 presents a discussion of capacity assignment allocations by "path" and "slice." In order to "assign" capacity to migrating customers, the local distribution company must identify a pro-rata share of system resources that would represent the amount of capacity needed to transport gas commodity to that customer in accordance with the customer's load profile, i.e. historical usage. Using a "slice of the system approach," the LDC would assign a pro-rata share of each upstream contract in the company's portfolio to the customer. Using a "path" approach, the LDC would assign a pro-rata share of capacity along a specific contract path (wellhead to city gate). Both approaches can be utilized within a mandatory assignment process while maintaining system reliability. Marketers support the "path" approach because they are likely to receive fewer "pieces" of capacity, i.e., they accept assignment of capacity along a path that consists of a subset of the company's available contracts, rather than a pro-rata slice of every contract. Thus, in their opinion, the "path" approach presents marketers with fewer administrative barriers and is easier to manage.

The principal difficulty in implementing the "path" approach is that the costs of a particular path are unique and, as a result, some paths are more expensive than others. In order to rectify the disparity so no customer is disadvantaged, the local distribution companies would need to calculate a total average capacity cost and credit/debit suppliers

whose actual costs deviate from that average (marketers would be billed directly by the pipeline companies at rates corresponding to the specific paths). If the marketer's pipeline rates were higher than the company's weighted average pipeline rates, then the marketer would receive a credit from the company for the difference, and conversely, if the marketer's pipeline rates were lower than the weighted average, the marketer would receive a charge for the difference. The issue that arises, however, is that it is difficult to pinpoint and quantify the cost impacts of certain paths and to account accurately for basis differentials in the cost of supply from the wellhead. Thus, some cross-subsidization can occur between customers. Assignment of paths also creates problems with regard to the availability of less expensive or more flexible resources. Customers who migrate relatively early have the ability to select such capacity, leaving less attractive capacity to those customers who migrate at a later point. Moreover, as migration levels increase, it becomes increasingly difficult to create workable paths, and therefore, at some point it may be necessary to revert to a slice of the system approach.

C. Cost Responsibility

Discuss the role of current Department policy concerning cost responsibility and cost allocation when providing for cost recovery of gas supply resources. Indicate the extent to which each of the proposals for capacity assignment is consistent with existing precedent.

Discuss how a voluntary assumption program could be implemented in a way that would ensure that no stranded costs might result. If some stranded assets and costs are identified as a result of the voluntary assumption of capacity, how might those costs be recovered without imposing any additional charges upon the non-switching end-users or upon the LDCs? If transportation customers pay a proportional share of the stranded costs, will the playing field be level or will marketers be at a disadvantage and unable to compete?

The Department's ratemaking policies with regard to recovery of gas supply resources are clear and well-established. These policies embody the fundamental ratemaking principle that cost responsibility must follow cost incurrence in order to satisfy the Department's underlying goals of fairness and equity. Thus, in reviewing rate applications, the Department has repeatedly held that the cost allocation process should result in an overall level of rates for each rate class that reflects the costs incurred to serve that rate class. Generic Investigation of Rate Structures, D.P.U. 18810, at 14 (1977); Boston Edison Company, D.P.U. 1720, at 114 (1984); Eastern Edison Company, D.P.U. 1580, at 111-112 (1984); Bay State Gas Company, D.P.U. 92-111, at 54, 283-284, 311-312 (1992); Cambridge Electric Light Company, D.P.U. 92-250, at 163 (1993); Boston Gas Company, D.P.U. 93-60, at 410, 432 (1993); Commonwealth Gas Company, D.P.U. 94-123, at 4 (1994).

In accordance with this principle, gas companies have consistently allocated costs for commodity and capacity to customers in a manner that has been deemed by the Department to be proportionate to the use of such resources by such customers. See, e.g.,

Commonwealth Gas Company, D.P.U. 94-123, at 4 (1994). Thus, where a gas company has incurred necessary demand charges, which are fixed for the term of a contract and cannot be avoided, such costs have been allocated to those customers for whom those unavoidable costs have been incurred. If migrating customers were allowed to avoid such costs in any degree, such costs will be shifted to remaining customers in violation of the Department's long-held ratemaking principles and underlying equity goals.

Significantly, the Legislature and the Supreme Judicial Court have affirmed the appropriateness of the principle that customers for whom costs have been incurred should remain responsible for such costs upon their migration from the system. See Chapter 164 of the Acts of 1997, § 1G(g) (the "Act"); Massachusetts Institute of Technology v. Department of Public Utilities, 425 Mass. 856, 684 N.E.2d 585 (1997) ("MIT"); Stow v. Department of Public Utilities, 426 Mass. 341, 688 N.E.2d 1337 (1997) ("Stow").

In MIT, the Court held that the recovery of costs created as a result of customer migration "is in the public interest" and that approving such charges is within the broad supervisory power granted to the Department by the Legislature in G.L. c. 164, § 94. MIT at 876. With respect to the issue of cost recovery from remaining customers, the Court held in Stow that "[i]t is the [D]epartment's duty to protect ratepayers from the side effects of newly introduced competition, such as increased rates due to the departure of customers." Stow at 351. The Court concluded that transition costs must be recovered from the party(s) to whom they are attributable – mainly the departing customers – and not the utilities' remaining customers. Id. at 349, citing MIT at 872.

> To the extent that, one way or another, utilities pass their fixed costs on to ratepayers, the public interest requires that no group of customers bear an unfair share of these costs.

Id. The Court concluded that the overriding consideration of the Department for all aspects of its analysis, must be the Department's obligation to protect the interests of all customers, not just departing customers. Id. at 353. Similarly, the recent electric industry restructuring Act imposes the obligation on existing customers to pay for unavoidable costs incurred on their behalf when such customers elect to bypass the electric company. See Act at § 1G(g).

Under a voluntary system of capacity disposition, customers electing to migrate to transportation service who are permitted to leave behind unavoidable costs that were incurred on their behalf will, absent direct assignment of all such costs to transportation customers, shift additional costs to the remaining customers on a gas company's system. Such a result would be in direct conflict with the Department's long-standing principle that cost responsibility should follow cost incurrence. In contrast, a mandatory system of capacity disposition ensures that all costs that have been incurred to serve a gas company's customers will be directly borne by those same customers (and not some smaller subset thereof) when the transition is made to a competitive natural gas commodity market. Accordingly, a mandatory system of capacity disposition is consistent with the Department's fundamental ratemaking principle that customer cost responsibility should reflect and follow cost incurrence.

A voluntary assignment program will inevitably create transition costs because marketers are not obligated to elect and accept responsibility for the cost of the migrating

customer's pro rata share of capacity resources. Because the very essence of voluntary assignment is that marketers would have the flexibility to leave capacity and the associated costs behind as a customer migrates, it would be impossible to implement a voluntary assignment mechanism that would not result in the creation of transition costs. The question, then, is whether a voluntary plan could be implemented that would ensure cost recovery to the local distribution companies without imposing additional costs upon non-migrating customers. Unless all transition costs are assigned to migrating (transportation) customers responsible for the creation of such costs, some portion of the resulting transition costs must be shifted to remaining customers. In general, marketers object to the direct assignment of all transition costs to migrating customers because, from an economic perspective, it is similar to being assigned on a mandatory basis a pro-rata share of capacity at maximum tariffed rates. That is, if all charges associated with unelected capacity are assigned to transportation customers only, no costs are avoided and it is as if the migrating customer had taken the capacity at maximum rates.[32]

There are two additional issues that must be considered with regard to such a proposal. First, although such a cost-recovery mechanism may mimic mandatory capacity assignment on an economic basis, it does not require marketers to take assignment of the primary delivery points held by local distribution companies. Thus, reliability and deliverability remain a critical concern under such a proposal. It is also unclear how such

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32 Since this type of cost recovery effectively represents "economic mandatory assignment," all marketers would commence competition with the same cost structures, as is the case with mandatory assignment as proposed by the LDCs.

a mechanism would be administered and whether such a mechanism may, in itself, create cost-shifting concerns. For example, if net non-mitigable transition costs were aggregated and collected from all firm transportation customers, those customers that have taken a relatively high percentage of their pro rata share of capacity would bear a disproportionate share of the transition costs. Thus, customers and their suppliers would have the incentive to not take any capacity. Another method would be to calculate the transition cost on a customer-by-customer basis to reflect the level of capacity taken by that customer. This method would be extremely burdensome to administer and would raise difficulties with regard to appropriate allocation of mitigation revenues.

The Competitive Supplier Proposal incorporates a voluntary assignment mechanism, and therefore, includes a proposed cost-recovery mechanism for transition costs. The marketers suggest that, by flowing streams of costs and revenues into a pool, there is the potential that the pool could end up in an "over-collected" state at such time that an accounting is made. The marketers claim that, in such an event, non-migrating customers would not bear the burden of shifted transition costs. For all its complicated aspects, however, the plan essentially represents the netting of unelected capacity costs against revenues resulting from local distribution company mitigation efforts. More importantly, since non-migrating customers receive the benefits of capacity releases, off-system sales and other revenues relied upon in the marketers' proposal to reduce the net costs in the pool, funneling such revenues through the transition cost pool will decrease the level of cost offsets provided to the local distribution company's sales customers through the CGAC. Thus, non-migrating sales customers will still bear a burden of non-mitigable capacity costs.

D. Reliability of Unbundled Service

Identify those elements of unbundled service in which the introduction of unbundling might lead to a decline in the reliability of service. Discuss fully how reliability might be affected by particular elements of each unbundling option presented.

Preserving reliability of deliveries to the LDCs' customers is critical to a successful transition. Deliverability is the assurance that sufficient capacity is available to transport commodity to the city gate. Historically, capacity planning and procurement has been the responsibility and obligation of local distribution companies under statute and Department precedent. Unbundling services will not, in itself, threaten deliverability since competitive gas suppliers could serve their customers with the resources that the local distribution companies have procured in meeting their obligation to provide reliable and least-cost service to customers. In theory, in a fully competitive capacity market there would be an adequate supply of reasonably priced gas transportation capacity to ensure deliverability to the city gate. Thus, the threat to deliverability results not from the unbundling of services, but from the inability of the market to assume the planning role previously held by the local distribution companies. As long as the local distribution companies continue to have the obligation to plan and procure capacity resources and to assign those resources on a mandatory pro-rata basis, unbundling of services will have no effect on reliability. Reliability will be affected only as a result of a determination by the Department that alters the local distribution companies' planning responsibilities and obligations without a workably competitive market in place to fulfill that role.

E. Regulatory Oversight

Discuss the matters for which regulatory oversight will be required during the transition to fully unbundled service and after a full unbundling. Indicate the ways by which such oversight might be implemented in a manner that will not discourage the development and continued viability of competitive markets but will meet the public interest needs.

The LDCs anticipate that the Department will be required to maintain an active oversight role during the transition to full unbundling. Similar to the electric industry restructuring, there are a variety of regulatory functions that will need to be performed in order to facilitate a smooth transition to a fully competitive market while protecting the interests of Massachusetts customers.

In particular, the Department may need to establish new rules of procedure by which local distribution companies: (1) provide distribution service to customers in their service territories; (2) provide gas service to low-income customers in their service territory; (3) provide energy efficiency and DSM services to customers in their service territories; (4) provide default gas sales service to customers in their service territories that are not receiving gas sales service from a competitive supplier; (5) bill customers in their service territories; and (6) terminate distribution of gas service to customers for non-payment of bills. In addition, the LDCs believe that the Department would continue to review LDCs' CGAC filings on a semi-annual basis, consistent with current Department regulations and practice.

Regulation by the Department will also be necessary to address issues associated with the activities of competitive gas suppliers. It is assumed that the Department will license all competitive suppliers and brokers of natural gas in Massachusetts. Such regulations would also govern: (1) the billing and termination provisions applicable to licensed gas suppliers

and brokers; (2) the release of customer usage information; and (3) rules concerning appropriate security deposit and late payment charges by licensed gas suppliers and brokers.

Regulations concerning information disclosure requirements will also be needed during the transition to full unbundling. As in the electric industry, the purpose of such requirements would be to ensure that customers are presented with consistent information to evaluate services offered by licensed gas suppliers and brokers. Such information would accurately provide the customer with: (1) the price to be charged; (2) price variability information; (3) a toll-free number for customer service and complaints; (4) the terms of service that provides information concerning, inter alia, (i) actual pricing structure according to which the customer will be billed; (ii) length of contract; (iii) due date of bills; and (iv) any and all charges, fees and penalties. The LDCs anticipate that the Department's regulations and actions by the Attorney General with respect to his responsibilities under G.L. c. 93A would also provide guidance to gas suppliers and brokers concerning the appropriate means of disclosing information through advertising.

The Department should also maintain an active regulatory oversight role by establishing the complaint and dispute resolution procedures and associated penalties applicable to customer complaints or damage claims between customers and competitive suppliers of gas. The LDCs believe that regulatory oversight by the Department and the Attorney General in the areas of consumer protection, if implemented through appropriate regulations, will further the public interest and encourage (*not* discourage) the development and continued viability of competitive markets.

F. Responsibility for Reliable and Adequate Service

Discuss the responsibility for assuring reliable and adequate service to all end-users during the transition to unbundled service. Include a full discussion of the means by which the LDC and marketing parties could cooperate to assure the availability of the capacity required to provide continued reliable service, including a discussion of responsibility for new capacity contracts, contract renewals or terminations. Include a full discussion of the LDC's or marketer's obligation to serve customers during the transition to unbundling.

If it were clear that a workably competitive market exists or will exist within a certain time frame for upstream capacity resources, the Department could commence an implementation process that would remove the local distribution companies' obligation to serve and alter the local distribution companies' planning and contracting role. In order for the Department to commit to such a course of action, however, there must be certainty that the capacity market will be sufficiently competitive to ensure the availability of an adequate quantity of reasonably priced capacity resources. Such a determination is critical because once this process is undertaken, it cannot be reversed, i.e., once local distribution companies step out of the contracting role, they cannot ensure that adequate supplies will be available. If the market is not sufficiently competitive to ensure reliable capacity resources or the timing of the transition period does not coincide with the development of the requisite level of competition in the upstream capacity market, then the local distribution companies' obligation to serve in the interim period cannot be changed.

G. Downstream Assets

Discuss the means by which downstream capacity and assets might be allocated under unbundling and the process by which such decisions might be initiated and adopted.

There are two general approaches that might be used to make downstream capacity and assets available to customers in an unbundled environment. As with upstream resources,

downstream capacity and assets should be made available to all customers on a pro-rata basis. Since default sales service will include costs relating to downstream capacity and peaking service, customers not choosing to purchase from competitive suppliers will pay their share of downstream assets. For transportation customers, pro-rata shares of downstream assets can be allocated either through a mandatory "virtual" capacity-release mechanism or through the purchase of peaking service.

Under a virtual capacity-release system, a pro-rata share of downstream capacity assets would be computed for customers in the same manner as upstream capacity. Customers would pay for that pro-rata share and would be entitled to use the capacity, e.g., to inject gas into and withdraw gas from LNG facilities operated by or under contract with the local distribution company. The arrangement would constitute a "virtual" release of capacity because the operational parameters for maximum and minimum inventory levels during the year would be established by the operator of the facility, and the customer (or its marketer) wouldn't have complete flexibility in using the capacity. Each local distribution company would need to determine the extent to which it would be able to offer and manage such virtual releases of downstream capacity. Operational or logistical constraints in some cases may limit the extent to which marketers are permitted to place their own gas into the inventory of local distribution company facilities.

A second alternative for making downstream assets available for transportation customers would be a mandatory peaking service. A two-part rate design would be established for the peaking service to reflect the capacity and commodity portions of the service. The capacity portion, reflecting the customer's pro-rata share of downstream

capacity costs that have been allocated to the CGAC, would be a mandatory charge. To the extent that the customer wishes to use the commodity peaking resources of the local distribution company, a separate commodity charge would be applied for the gas actually purchased from the peaking facilities. The amount of gas that could be taken by the customer would be limited to the pro-rata level of capacity that is allocated to customer. This procedure will ensure that unavoidable costs associated with downstream capacity resources will not be shifted to other customers, but that customers will retain the choice as to whether they wish to purchase the peaking commodity or use alternatives.

A. **Statutory or Regulatory Changes Required to Implement Gas Unbundling**

Please identify and discuss any statutory or other changes that might be required for the Department to implement any element of the unbundling process.

The unbundling process, per se, does not necessarily require any statutory change for implementation. However, many of the issues that have been discussed under the general umbrella of "unbundling" could potentially conflict with statutory provisions or would be well-served by statutory input. To the extent that the Department were to adopt the LDCs' approach including a portfolio auction and mandatory capacity assignment, there would be no immediate statutory changes needed since the underlying obligation to serve, billing and termination issues, etc. would not be significantly altered during the transition period. The LDCs note, however, that many consumer-related issues, were addressed in the Act, some

of which directly apply to the gas industry. Any proposals that would conflict with the new statute would, of course, require legislative change, and the industry must be mindful of the role of the Legislature in any change that would restructure the gas industry.

I. Domestic Experience with Unbundled Service

Identify those programs of unbundling that have been in effect or proposed for other jurisdictions in the United States.

Attached for the Department's information as Exhibit 3 is a Quarterly Review of LDC Regulatory Activity, prepared by Salomon Smith Barney that summarizes the restructuring efforts underway in other states. Also attached as Exhibit 3 is an analysis prepared by the American Gas Association regarding customer choice in the natural gas industry.[33]

The LDCs recognize that many issues presented by unbundling efforts at the state level are common to all state public utility commissions and that information regarding the issues and policy determinations faced by other state commissions may be instructive. At the same time, the LDCs note that unbundling efforts in Massachusetts are unique in that Massachusetts is quite literally at the end of the pipe and that any policy determinations made in other jurisdictions reflect the factual circumstances and value judgments of those state commissions. The LDCs believe that the Department must make policy determinations in the context of the legislative and regulatory policy framework of the Commonwealth and with due regard to the physical constraints of the system in consideration of any particular

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[33] This analysis is due to be updated on May 7, 1998. The LDCs will provide that updated analysis to the Department at that time.

unbundling plan.

J. Consumer Education

Describe the extent and type of public and end-user education that will be required to assure the smooth implementation and viability of competitive, unbundled gas service. Discuss those efforts that have been implemented elsewhere with apparent success.

The Department has stated that the transition to competition in the gas industry must be orderly and expeditious and minimize customer confusion. Boston Gas Company, D.P.U. 96-50, at 222 (1996) (Phase I); see also Electric Industry Restructuring Plan: Model Rules and Legislative Proposal, D.P.U. 96-100, at 37 (1996). Customer education is a beneficial and indispensable tool for reaching the Department's objective. The LDCs believe that any customer education program undertaken should be designed to inform customers of the following elements: (1) customers need to understand that they will have the opportunity to switch to a competitive supplier; (2) customers need to understand who will be responsible for providing particular services; (3) customers need assurances that the LDC will work with them to help them achieve their objectives whether switching to a competitive supplier or remaining as a sales service customer. The LDCs are committed to undertaking such customer education efforts in any manner deemed appropriate by the Department.

IV. CONCLUSION

The LDCs are committed to achieving the Department's goal of encouraging the development of a more competitive gas market while ensuring the availability of safe and reliable gas service at the lowest possible cost. The LDCs appreciate the opportunity to

address the important policy issues that underlie the transition to a competitive natural gas market in Massachusetts.

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